Remarks of John M. Reich
Director, Office of Thrift Supervision
to the California Bankers Association
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Good morning. It is a pleasure to be here in Newport Beach with my friends from the California Bankers Association and their partner in this Summit, Carpenter & Company. I've been asked to share my thoughts on the thrift charter and the national banking environment generally. I've learned two things after over 45 years in and around the banking business. First, continuing change and evolution in the banking industry are constants. And second, there are always unique issues and opportunities for depository institutions.

The thrift charter, in particular, offers a number of strategic advantages for retail-based community banking operations in today's banking environment. In my remarks this morning, I will touch upon some of these issues as well as several of the current challenges faced by banking organizations.

California has always been a strategic state for the thrift charter. Many of the largest OTS-regulated thrifts operate out of California and/or have a significant stake in the California housing market. In fact, OTS-regulated thrifts holding approximately 15.8 percent of industry assets are headquartered in California. That number does not include significant nationwide mortgage holdings by OTS-regulated thrifts with a significant presence in California. Overall, these institutions represent approximately 44 percent of industry-assets.

California has also been a strategic market for the development of numerous mortgage innovations in the U.S. during the last 25 years. Many of these innovations came from OTS-regulated thrifts addressing the special needs and unique circumstances of the California housing market. For example, several OTS-regulated thrifts were innovators in alternative rate mortgages (ARMs) that have made homeownership affordable and sustainable by many Californians. These ARM products were developed and underwritten responsibly to enable borrowers to stay in their homes without undue financial hardship.

Subprime Lending Concerns and the California Experience

Today's headlines are replete with stories about questionable and predatory lending practices in both the prime and subprime mortgage markets. The fact remains, however, that properly structured and well-underwritten ARMs are critical mortgage loan products for many Americans, particularly in competitive housing markets such as California.

Last year, OTS-regulated thrifts originated approximately 22 percent of U.S. mortgages. Of these, we estimate that 23 percent were ARMs. Subprime hybrid ARMs accounted for just 17 percent of all ARM originations by insured institutions in 2006. Thus, we estimate that subprime hybrid ARMs accounted for a very small percentage of aggregate mortgage originations by OTS-regulated thrifts in 2006.

While representing a small percentage of mortgages originated by thrifts, and 13 percent of the overall mortgage market, subprime hybrid ARMs have brought to light in stark terms a phenomenon that has been affecting the mortgage markets for the last several years. The issue is lax underwriting.

Aggressive and predatory lending practices by various mortgage originators have caused real problems in the marketplace. However, it is important not to overlook another culprit affecting the mortgage markets – unsafe and unsound underwriting practices. Coupled with systems and investor funding mechanisms that effectively encouraged quantity over quality, we witnessed a meltdown in some mortgage market sectors of a common sense lending principle – do not make a loan without understanding the nature of its repayment risk.

A year ago at a conference in New York, I spoke about concerns we had at OTS with an overall slippage in underwriting due to increased competition in certain markets segments and areas. In particular, I described examples provided by our examiners where loan pricing was misaligning with credit risk solely due to competition and the desire for loan volume. I also noted that we were seeing an increased liberalization of terms by some institutions in order to maintain their loan volume. Particularly troubling was the fact that institutions were effectively taking on greater risks with less vigilance regarding their overall program requirements.

Today, we see the consequences of some of this activity. Ironically, it was the use of products gauged to take account of and adjust for underwriting and repayment risk that enabled the abandonment of risk-based underwriting criteria by some originators. The good news is that this does not appear to be the case with most insured depository institutions. In fact, most of the current fallout has been outside of insured institutions. As of year-end 2006, repossessed assets represented 0.09 percent of total industry assets for OTS-regulated thrifts. A breakdown by loan type shows that 0.29 percent of prime mortgages (0.11 percent in California), and 3.63 percent of Alt-A and subprime mortgages (2.73 percent in California) held by OTS-regulated thrifts were in foreclosure. This compares well to the national averages of 0.85 percent (0.24 percent in California) of prime mortgages in foreclosure, and 8.85 (6.16 percent in California) of Alt-A and subprime mortgages in foreclosure.

I believe a significant reason for the difference in foreclosure rates nationally and for OTS-regulated thrifts is the understanding and experience of thrifts with the use of these products. The California experience of OTS-regulated thrifts is particularly informative. A number of thrifts operating in California have experience with various types of ARMs through different economic cycles. These institutions know how the products perform under various economic conditions and how to structure the loans to be maintained and repaid by borrowers.

California institutions continue to be leaders in developing and implementing strategic innovations in the U.S. mortgage market. We look forward to working with many of you in the months ahead to identify solutions on how to restore safe and sound underwriting to all segments of the mortgage origination process, as well as to fight predatory lending. Frankly, a particular concern of mine at this point is avoiding a pendulum effect that results in undue constraint on housing credit. We need to address problems with lax underwriting and predatory lending without adversely impacting affordable housing. We will continue to work with California-based institutions that are leaders in protecting affordable housing options for low- and moderate-income households in the challenging California housing market.

Operating Strategies under the Federal Thrift Charter

In addition to innovations in the mortgage markets, the experience of California thrifts with the federal thrift charter highlights certain strategic benefits that I want to touch on today.

Many industry observers identify the statutory preemption authority available to federal thrifts as the key strategic benefit for operating out of the federal thrift charter, particularly for institutions conducting nationwide mortgage lending operations. While the importance of operating under established uniform national standards is clear, particularly for nationwide mortgage lenders or institutions with national retail lending operations, certain other advantages of the thrift charter are often overlooked.

One such advantage of the federal thrift charter is the ability to branch interstate, on a nationwide basis, without limitation. The charter offers institutions based in any state in the country the ability to branch into any other state either by acquisition or by establishing a de novo branch. De novo branching, in particular, provides unique advantages for strategic, targeted branching for an institution that has a business model and operating strategy that can be adapted to another market in another state. It also provides the opportunity to implement and stretch a successful operating model without concern about regulatory barriers or constraints on growth.

Perhaps the least appreciated of the advantages of the federal thrift charter is the ability to operate with a unified federal regulator at both the insured depository institution and holding company level. Minimizing regulatory burden, costs and overlap is a key strategic benefit. Further enhancing this benefit is an OTS supervisory strategy that focuses on the risks posed to the insured institution – and federally insured deposits – by the entire holding company enterprise. Enterprise risk management is key to the OTS's holding company oversight strategy. While we apply this supervisory approach to all holding company structures, it is particularly effective and important in regulating financial conglomerates that have multiple financial subsidiaries and wide-ranging national and/or international operations.

In fact, the European Union (EU) recognizes the OTS's oversight in connection with the agency's complex and international conglomerates program. EU regulators, including the UK's Financial Services Authority and France's Commission Bancaire, have designated the OTS a consolidated coordinating regulator under the EU's financial conglomerates directive on three occasions, including the first time that a U.S. regulator received the designation, in December 2004.

A final observation on the federal thrift charter that I previously mentioned but want to impress upon you is that the charter is tailored to accommodate the operations and activities of retail-based lending and deposit-taking institutions. While this authority includes significant flexibility to engage in small business lending activities, it does not permit whole-scale commercial banking. We are interested, however, in ensuring that thrifts that engage in small business lending as part of their overall retail focus are not confined by what some view as an overly restrictive 20 percent of assets limit for this activity. In this regard, we continue to seek legislation to provide common sense relief on the current 20 percent of assets small business lending limit.

An additional concern we have in this context is the view that certain other limitations on the federal thrift charter are overly restrictive. A case in point is the qualified thrift lender, or QTL, test. In fact, the federal thrift charter is flexible enough for almost all retail-oriented operating strategies. In this regard, it is worth noting that a significant majority of insured depository institutions, including banks and credit unions, currently qualify under the QTL test. We also work with institutions to highlight the flexibility available under the various other statutory lending restrictions to avoid structuring their portfolio in a manner that limits their operations and future operating strategy.

Retail community banking is a rapidly growing segment of the financial services world. Over the last five years, thrift industry assets grew from $978 billion at year end 2001 to $1.41 trillion as of December 2006. Even with taking into account several sizable defections from the charter, this represents a robust five-year growth rate of 44.3 percent. By any measure, these are excellent numbers.

As the retail community banking sector grows, I believe the thrift charter is well positioned to provide a structural and regulatory alternative both to established financial services businesses and to new entrants that are working to grow market share in this area. The unique advantages and regulatory structure that I just described ensure that thrifts are able to follow their customer base and the growth of their business from one end of the country to the other - all with minimal regulatory burden and overlap.

A testament to this is that the charter is deployed in neighborhood community banks all across America. It is also used by leading nationwide lenders, investment banks offering a full array of financial services, and global conglomerates involved in a wide array of diverse businesses. All of these organizations have the charter for reasons as diverse as their underlying businesses and the markets they serve. The charter provides a proven, retail-based operating strategy for insured depository institutions and the holding companies that control these institutions.

Pending Policy and Legislative Issues

A question I am often asked that has an ever-evolving answer is "What's hot in Washington these days?" As always, there are many things. Certain issues, such as the commercial real estate (CRE) lending guidance and the nontraditional mortgage (NTM) lending guidance, appear to be assimilated into the supervisory framework. These issues are no longer the topic of daily debate, but I am interested in any observations you have on either of these items.

By contrast, debate on the Basel IA and Basel II implementation processes is likely to be with us for some time to come. The banking agencies are currently reviewing the comments received on the Basel IA and Basel II proposals, which closed on March 26. I hope many of you weighed in during the comment process to guide us on the very important issues raised by these proposals. The potential impact on the banking industry of the issues presented in both Basel IA and Basel II is substantial.

Another topical issue, of course, is the ongoing policy debate on subprime and predatory lending issues. As you know, the Federal bank regulators recently issued proposed guidance addressing abuses in subprime mortgage lending. I encourage you to let us know what you think of these proposed guidelines. There have been hearings on subprime and predatory lending in both the House and Senate this spring. We expect legislative activity on these issues.

I am optimistic about the pursuit and the prospects of another regulatory burden relief bill this year. Although it is not clear at the moment what the prospects are for further legislative relief, I will continue to deliver the message about the need for relief from accumulated regulatory burden to Capitol Hill and to all who will listen. I encourage you to do the same, particularly with the members of your legislative delegation in Washington, DC. A quick observation in this regard is that we already have two stand-alone pieces of burden relief legislation. One updates and improves the existing authority for thrifts and banks to make public welfare investments and the other provides for a "seasoned customer" exception for the filing of currency transaction reports. The House passed both of these bills since it convened in January.

Other legislation that will shape the agenda of the House Financial Services Committee and Senate Banking Committee includes, of course, GSE reform and activity on the industrial loan company (ILC) bill pending in the House. While GSE reform will certainly impact all of us, the policy debates on the various issues are matters in which the OTS is not directly involved.

We are directly involved, however, with the ILC bill since it impacts several of the larger holding company structures we oversee. There are several important issues in the ILC context – among the most critical of which is ensuring that holding company conglomerates that own ILCs are not subject to duplicative oversight by multiple federal regulators. It is important to preserve this important regulatory relief provision from the Gramm-Leach-Bliley Act.

A constantly evolving area that I believe has significant potential for legislative activity going forward is the privacy debate and issues surrounding data security and identity theft. All of these issues involve a common theme of the ongoing impact of technology and its application and impact on our lives. This is an area of tremendous proportions considering the important policy issues implicit in the debate.

Future of the Bank and Thrift Regulatory Structures

A final issue I want to touch upon before concluding is the future of the thrift charter and the OTS. While it may seem unusual to raise this issue now given everything I have just said, I believe my remarks bolster my observations on the charter and future of the OTS. Yes, there are greater similarities between commercial banks and thrifts than there were perhaps 25 years ago, but important differences and distinctions remain. One of these is a different regulatory structure.

I am certain that many of you agree with the benefit of having divergent views represented in the regulatory structure for insured institutions and their holding companies. Different views and approaches not only permit healthy regulatory competition, but also promote the development of sound and well thought out regulatory and supervisory policies. Regulatory competition keeps regulators on their toes, inhibiting extremist behavior, and encourages developing creative and innovative solutions for regulated institutions.

Since its formation in 1989, the OTS has consistently weathered challenges to its continued existence. While this ebb and flow continues, the agency continues to carry out its statutory responsibility of protecting the safety and soundness of the thrift industry and overseeing the many companies that control OTS-regulated thrifts. As with the OCC, no taxpayer dollars are spent for this oversight. Rather, the institutions we regulate are assessed to support the cost of OTS supervision and oversight, and we continue to manage and conduct our operations in the black, with an appropriate reserve for contingencies.

In addition to having a critical mass of institutions to supervise, the OTS and OCC continue to have different regulatory charges and both are active, major players in formulating policy on the future of the banking and thrift industries. Continuing differences between banks, thrifts and the supervision and oversight of bank and thrift holding companies also weigh strongly in favor of the continuation of the existing regulatory structure. In fact, one of the most significant reasons for maintaining the current structure lies in the absence of any significant constituency to change it. I believe there are numerous reasons for this, not the least of which is the continuing health and vibrancy of the separate banking and thrift industries

A final point worth noting is the continued importance of maintaining freedom of charter choice for financial institutions. Throughout its existence, the OTS has maintained and protected the freedom of charter choice. An institution should not be captive to an operating structure that no longer fits its operating strategy. While it is sound public policy to continue to identify ways to improve bank, thrift and credit union charters to make each more competitive, public policy should not be turned on its head to create competitive advantages for one charter over the others. Sound public policy requires the preservation of charters and charter choice.

Conclusion

In concluding, let me say that I appreciate the opportunity to speak to you today in beautiful southern California, and I look forward to continuing to work with you. I am happy to take questions as time permits.